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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

☒ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended September 30, 2001

OR

☐ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number 001-13083

WELLPOINT HEALTH NETWORKS INC.

(Exact name of registrant as specified in its charter)

Delaware

(State or other jurisdiction of incorporation or organization)

95-4635504

(IRS Employer Identification No.)

1 WellPoint Way, Thousand Oaks, California

(Address of principal executive offices)

91362

(Zip Code)

Registrant's telephone number, including area code **(818) 234-4000**

**Not Applicable**  
(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ☒ No ☐

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date:

Title of each class	Outstanding at November 6, 2001
Common Stock, \$0.01 par value	63,766,101 shares

WellPoint Health Networks Inc.

Quarterly Report on Form 10-Q for the Quarter Ended September 30, 2001

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**ITEM 1. Financial Statements**

**WellPoint Health Networks Inc.**  
Consolidated Balance Sheets  
(Unaudited)

<i>(In thousands, except share data)</i>	<b>September 30, 2001</b>	<b>December 31, 2000</b>
<b>ASSETS</b>		
Current Assets:		
Cash and cash equivalents	\$ 530,376	\$ 566,889
Investment securities, at market value	3,933,673	3,096,350
Receivables, net	983,154	699,868
Deferred tax assets	75,588	77,757
Other current assets	90,724	59,545
Total Current Assets	5,613,515	4,500,409
Property and equipment, net	213,796	151,031
Intangible assets, net	437,347	165,164
Goodwill, net	717,932	418,120
Long-term investments, at market value	120,093	116,811
Deferred tax assets	19,298	92,982
Other non-current assets	100,957	60,189
Total Assets	\$ 7,222,938	\$ 5,504,706
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current Liabilities:		
Medical claims payable	\$ 1,812,910	\$ 1,566,569
Reserves for future policy benefits	66,100	58,085
Unearned premiums	273,034	232,132
Accounts payable and accrued expenses	821,569	513,637
Experience rated and other refunds	244,531	249,725
Income taxes payable	127,152	53,898
Other current liabilities	545,671	398,867
Total Current Liabilities	3,890,967	3,072,913
Accrued postretirement benefits	87,794	71,510
Reserves for future policy benefits, non-current	227,151	267,552
Long-term debt	887,151	400,855
Other non-current liabilities	106,445	47,459
Total Liabilities	5,199,508	3,860,289
Stockholders' Equity:		
Preferred Stock—\$0.01 par value, 50,000,000 shares authorized, none issued and outstanding	—	—
Common Stock—\$0.01 par value, 300,000,000 shares authorized, 71,390,971 issued at September 30, 2001 and December 31, 2000	714	714
Treasury stock, at cost, 7,754,468 and 8,566,399 shares at September 30, 2001 and December 31, 2000, respectively	(483,807)	(536,524)
Additional paid-in capital	996,365	983,028
Retained earnings	1,441,287	1,145,464
Accumulated other comprehensive income	68,871	51,735
Total Stockholders' Equity	2,023,430	1,644,417
Total Liabilities and Stockholders' Equity	\$ 7,222,938	\$ 5,504,706

See the accompanying notes to the consolidated financial statements.

**WellPoint Health Networks Inc.**  
**Consolidated Income Statements**  
**(Unaudited)**

	Three Months Ended September 30,		Nine Months Ended September 30,	
<i>(In thousands, except earnings per share)</i>	2001	2000	2001	2000
Revenues:				
Premium revenue	\$ 3,025,184	\$ 2,184,639	\$ 8,384,379	\$ 6,307,746
Management services revenue	156,191	115,376	444,206	336,719
Investment income	64,097	53,309	177,746	142,940
	3,245,472	2,353,324	9,006,331	6,787,405
Operating Expenses:				
Health care services and other benefits	2,471,152	1,762,220	6,824,849	5,097,757
Selling expense	127,277	101,313	363,777	290,825
General and administrative expense	429,234	324,658	1,217,690	932,052
	3,027,663	2,188,191	8,406,316	6,320,634
Operating Income	217,809	165,133	600,015	466,771
Interest expense	14,590	5,657	36,332	18,430
Other expense, net	19,399	12,749	51,331	33,805
Income before Provision for Income Taxes	183,820	146,727	512,352	414,536
Provision for income taxes	75,374	57,223	207,474	161,721
Net Income	\$ 108,446	\$ 89,504	\$ 304,878	\$ 252,815
Earnings Per Share	\$ 1.70	\$ 1.43	\$ 4.81	\$ 4.04
Earnings Per Share Assuming Full Dilution	\$ 1.64	\$ 1.38	\$ 4.64	\$ 3.91
Weighted Average Shares Outstanding	63,605	62,491	63,319	62,511
Fully Diluted Weighted Average Shares Outstanding	66,456	65,141	65,996	64,938

See the accompanying notes to the consolidated financial statements.

WellPoint Health Networks Inc.

Consolidated Statement of Changes in Stockholders' Equity

(Unaudited)

(In thousands)	Common Stock									
	Preferred Stock	Issued		In Treasury		Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income	Total	
		Shares	Amount	Shares	Amount					
Balance as of December 31, 2000	\$ —	71,391	\$ 714	8,566	\$ (536,524)	\$ 983,028	\$ 1,145,464	\$ 51,735	\$ 1,644,417	
Stock grants to employees and directors				(12)	757					757
Stock issued for employee stock option and stock purchase plans				(875)	59,393	13,337				72,730
Stock repurchased, at cost				75	(7,433)					(7,433)
Net losses from treasury stock reissued								(9,055)		(9,055)
Comprehensive income										
Net income							304,878			304,878
Other comprehensive income, net of tax										
Change in unrealized valuation adjustment on Investment securities, net								27,087		27,087
Cash flow hedges, net								(9,689)		(9,689)
Foreign currency adjustments, net								(262)		(262)
Total comprehensive income							304,878	17,136		322,014
Balance as of September 30, 2001	\$ —	71,391	\$ 714	7,754	\$ (483,807)	\$ 996,365	\$ 1,441,287	\$ 68,871	\$ 2,023,430	

See the accompanying notes to the consolidated financial statements.

**WellPoint Health Networks Inc.**  
Consolidated Statements of Cash Flows  
(Unaudited)

<i>(In thousands)</i>	Nine Months Ended September 30,	
	2001	2000
<b>Cash flows from operating activities:</b>		
Net Income	\$ 304,878	\$ 252,815
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization, net of accretion	79,401	55,737
Loss on sales of assets, net	8,713	14,972
Provision (benefit) for deferred income taxes	78,416	(12,252)
Amortization of deferred gain on sale of building	(3,320)	(3,320)
Accretion of interest on zero coupon convertible subordinated debentures	2,270	2,224
(Increase) decrease in certain assets:		
Receivables, net	(119,269)	(144,762)
Other current assets	(21,218)	(5,016)
Other non-current assets	(3,602)	727
Increase (decrease) in certain liabilities:		
Medical claims payable	(12,034)	178,879
Reserves for future policy benefits	(40,201)	(21,254)
Unearned premiums	7,032	3,807
Accounts payable and accrued expenses	126,256	97,328
Experience rated and other refunds	(8,724)	9,860
Income taxes payable	43,216	(71,104)
Other current liabilities	87,641	25,668
Accrued postretirement benefits	2,937	1,855
Other non-current liabilities	(86,716)	692
Net cash provided by operating activities	445,676	386,856
<b>Cash flows from investing activities:</b>		
Investments purchased	(3,174,306)	(2,731,253)
Proceeds from investments sold and matured	2,766,619	2,491,508
Property and equipment purchased	(68,465)	(34,410)
Proceeds from property and equipment sold	9,130	1,842
Acquisition of new businesses, net of cash acquired	(556,192)	(142,730)
Net cash used in investing activities	(1,023,214)	(415,043)
<b>Cash flows from financing activities:</b>		
Net borrowing of long-term debt under revolving credit facilities	35,000	50,000
Net borrowing of long-term debt under 6 <sup>3</sup> / 8 % Notes due 2006	449,026	—
Proceeds from issuance of common stock	64,432	56,601
Common stock repurchased	(7,433)	(174,602)
Net cash provided by (used in) financing activities	541,025	(68,001)
Net decrease in cash and cash equivalents	(36,513)	(96,188)
Cash and cash equivalents at beginning of period	566,889	505,014
Cash and cash equivalents at end of period	\$ 530,376	\$ 408,826

See the accompanying notes to the consolidated financial statements.



**WellPoint Health Networks Inc.**  
**Notes to Consolidated Financial Statements**  
**(Unaudited)**

**1. Organization**

WellPoint Health Networks Inc. (the "Company" or "WellPoint") is one of the nation's largest publicly traded managed health care companies. As of September 30, 2001, WellPoint had approximately 10.0 million medical members and approximately 44.3 million specialty members. The Company offers a broad spectrum of network-based managed care plans. WellPoint provides these plans to the large and small employer, individual and senior markets. The Company's managed care plans include preferred provider organizations ("PPOs"), health maintenance organizations ("HMOs"), point-of-service ("POS") plans, other hybrid medical plans and traditional indemnity plans. In addition, the Company offers managed care services, including underwriting, actuarial service, network access, medical cost management and claims processing. The Company also provides a broad array of specialty and other products and services including pharmacy, dental, utilization management, life insurance, preventive care, disability, behavioral health, COBRA and flexible benefits account administration. The Company markets its products in California primarily under the name Blue Cross of California, in Georgia primarily under the name Blue Cross Blue Shield of Georgia and in other states primarily under the name UNICARE. Historically, the Company's primary market for managed care products has been California. The Company holds the exclusive right to market its products under the Blue Cross name and mark in California and under the Blue Cross Blue Shield name and mark in Georgia.

**2. Basis of Presentation**

The accompanying unaudited consolidated financial statements of WellPoint, in the opinion of management, reflect all material adjustments (which are of a normal recurring nature) necessary for a fair statement of its financial position as of September 30, 2001, the results of its operations for the quarter and nine months ended September 30, 2001 and 2000, cash flows for the nine months ended September 30, 2001 and 2000 and its changes in stockholders' equity for the nine months ended September 30, 2001. The results of operations for the interim periods presented are not necessarily indicative of the operating results for the full year.

**3. Acquisitions**

On March 15, 2001, the Company completed its acquisition of Cerulean Companies, Inc. ("Cerulean"), the parent company of Blue Cross Blue Shield of Georgia, Inc., which served approximately 1.9 million medical members in the state of Georgia as of March 31, 2001. This acquisition was accounted for under the purchase method of accounting and accordingly, the consolidated results of operations of the Company include the results of Cerulean from the date of acquisition. The cash purchase price was \$700.0 million.

As a result of the acquisition of Cerulean, the Company estimates that it will incur \$114.2 million in expenses primarily related to change in control payments to Cerulean management and transaction costs. Generally accepted accounting principles require that these expenses, which are not associated with the generation of future revenues and have no future economic benefit, be reflected as assumed liabilities in the allocation of the purchase price to the net assets acquired.

Cash of \$200.0 million and debt of \$500.0 million were used to purchase net assets with a fair value of approximately \$314.2 million. Goodwill and other intangibles totaling \$618.9 million includes \$118.9 million of deferred taxes and \$114.2 million of the aforementioned assumed liabilities. Goodwill and other intangibles are being amortized on a straight-line basis over 20 years for goodwill and

ranging from five to 40 years for other intangible assets. The purchase price allocation between goodwill and identifiable intangible assets had not been finalized as of September 30, 2001.

On March 1, 2000, the Company completed its acquisition of Rush Prudential Health Plans ("Rush Prudential"). Rush Prudential offers a broad array of products and services ranging from HMO products to traditional PPO products. The acquisition significantly increased the Company's Illinois medical membership to nearly 600,000 members as of March 31, 2000. Subsequent to the acquisition, the acquired business has been operated as UNICARE Health Plans. The transaction, which was financed with both cash from operations and debt from the Company's existing revolving credit facility, is valued at approximately \$202.6 million. This acquisition was accounted for under the purchase method of accounting. Cash of \$102.6 million and debt totaling \$100.0 million were used to purchase net assets with a fair value of approximately \$19.4 million, resulting in goodwill and other intangibles totaling \$215.5 million. The resulting goodwill includes \$32.3 million of deferred tax liabilities relating to identified intangibles.

On December 5, 2000, the Company completed its acquisition of a mail order pharmacy fulfillment facility from RxAmerica LLC ("RxAmerica"). RxAmerica is a pharmacy benefits management joint venture between Albertson's, Inc. and Longs Drugs Stores California, Inc. Subsequent to the acquisition, the business was re-named PrecisionRx. This acquisition was accounted for under the purchase method of accounting.

In accordance with the requirements of APB Opinion No. 16, "Business Combinations," the following unaudited pro forma summary presents revenues, net income and per share data of WellPoint as if the acquisitions of Cerulean, Rush Prudential and Precision Rx had occurred on January 1, 2000. The pro forma information includes the results of operations for the period prior to the acquisition, adjusted for interest expense on long-term debt incurred to fund the acquisitions, amortization of goodwill and intangible assets and the related income tax effects.

The pro forma financial information is presented for informational purposes only and may not be indicative of the results of operations had the Company been a single entity during the three months and nine months ended September 30, 2001 and 2000, nor is it necessarily indicative of future results of operations. Pro forma earnings per share assuming full dilution is based on 66.5 million and 65.1 million weighted average shares outstanding during the three months ended September 30, 2001 and 2000, respectively. For the nine months ended September 30, 2001 and 2000, pro forma earnings per share assuming full dilution is based on 66.0 million and 64.9 million weighted average shares outstanding, respectively.

(In thousands, except per share data)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2001	2000	2001	2000
Revenues	\$ 3,245,472	\$ 2,910,243	\$ 9,487,392	\$ 8,458,875
Net Income	\$ 108,446	\$ 82,859	\$ 311,831	\$ 247,687
Earnings Per Share				
Basic	\$ 1.70	\$ 1.33	\$ 4.92	\$ 3.96
Diluted	\$ 1.64	\$ 1.28	\$ 4.75	\$ 3.84

#### 4. Long Term Debt

##### *6<sup>3</sup> / 8 % Notes due 2006*

On June 15, 2001, the Company issued \$450.0 million aggregate principal amount at maturity of 6<sup>3</sup> / 8 % Notes due June 15, 2006 (the "Notes"). The net proceeds of this offering totaled approximately \$449.0 million. The net proceeds from the sale of the Notes were used for repayment of indebtedness under the Company's revolving credit facilities. The Notes bear interest at a rate of 6<sup>3</sup> / 8 % per annum, payable semi-annually in arrears on June 15 and December 15 of each year commencing December 15, 2001. Interest is computed on the basis of a 360-day year of twelve 30-day months.

The Notes may be redeemed, in whole or in part, at the Company's option at any time. The redemption price for any Notes redeemed will be equal to the greater of the following amounts: 1) 100% of the principal amount of the Notes being redeemed on the redemption date; and 2) the sum of the present values of the remaining scheduled payments of principal and interest on the Notes being redeemed on that redemption date (not including any portion of any payments of interest accrued to the redemption date) discounted to the redemption date on a semiannual basis at the Treasury rate as determined by the designated Reference Treasury Dealer (Salomon Smith Barney Inc. or UBS Warburg LLC or their respective successors), plus 25 basis points. In each case, the redemption price will also include accrued and unpaid interest on the Notes to the redemption date.

The Notes are unsecured obligations and rank equally with all of the Company's existing and future senior unsecured indebtedness. All existing and future liabilities of the Company's subsidiaries are and will be effectively senior to the Notes. The indenture governing the Notes contains a covenant that limits the Company's ability and that of the Company's subsidiaries to create liens on Company property or assets to secure certain indebtedness without also securing the Notes.

##### *Revolving Credit Facility*

Effective as of March 30, 2001, the Company entered into two new unsecured revolving credit facilities allowing aggregate indebtedness of \$1.0 billion. Upon execution of these facilities, the Company terminated its prior \$1.0 billion unsecured revolving facility. Borrowings under these facilities (which are generally referred to collectively in this Quarterly Report on Form 10-Q as the Company's "revolving credit facility") bear interest at rates determined by reference to the bank's base rate or to the London Inter Bank Offered Rate ("LIBOR") plus a margin determined by reference to the then-current rating of the Company's unsecured long-term debt by specified rating agencies. One facility, which provides for borrowings of up to \$750,000,000, expires as of March 30, 2006, although it may be extended for up to two additional one-year periods under certain circumstances. The other facility, which provides for borrowings of up to \$250,000,000, expires as of March 30, 2002. Any amount outstanding under this facility as of March 30, 2002 may be converted into a one-year term loan at the option of the Company. Borrowings under the facilities are made on a committed basis or, in the case of the \$750.0 million facility, pursuant to an auction bid process. The \$750.0 million facility also contains sublimits for letters of credit and "swingline" loans. Each credit agreement requires the Company to maintain certain financial ratios and contains restrictive covenants, including restrictions on the occurrence of additional indebtedness and the granting of certain liens, limitations on acquisitions and investments and limitations on changes in control. The total amount outstanding under these facilities was \$285.0 million as of September 30, 2001. The total amount outstanding under the Company's prior revolving credit facility was \$250.0 million as of December 31, 2000.

### *Zero Coupon Convertible Subordinated Debentures*

On July 2, 1999, the Company issued \$299.0 million aggregate principal amount at maturity of zero coupon convertible subordinated debentures due 2019 (the "Debentures"). The proceeds totaled approximately \$200.8 million. The Debentures accrue interest at a yield to maturity of 2.0% per year compounded semi-annually. Holders have the option to convert the Debentures into the Company's common stock at any time prior to maturity at a rate of 6.797 shares per \$1,000 principal amount at maturity. In lieu of delivering shares of common stock upon conversion of any Debentures, the Company may elect to pay cash for the Debentures in an amount equal to the last reported sales price of its common stock on the trading day preceding the conversion date. The debentures are subordinate in right of payment to all existing and future senior indebtedness.

On October 6, 1999, the Board of Directors authorized the repurchase of some or all of the Company's Debentures for cash. The Company did not repurchase any Debentures during the nine months ended September 30, 2001 and year ended December 31, 2000. During the year ended December 31, 1999, the Company repurchased \$81.0 million in aggregate principal amount at maturity of the Company's Debentures at a total purchase price of \$49.8 million. The gain on such repurchase is shown on the Company's income statement as an extraordinary gain, net of applicable tax.

As of September 30, 2001 and December 31, 2000, the Company had \$153.1 million and \$150.9 million (based upon the original issue price plus accrued interest), respectively, of Debentures outstanding. Accrued interest related to the Debentures was \$6.7 million and \$3.1 million, respectively, as of September 30, 2001 and December 31, 2000.

5. Earnings Per Share

The following is an illustration of the dilutive effect of the Company's potential common stock on earnings per share ("EPS"). There were no antidilutive securities in any of the periods presented.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2001	2000	2001	2000
<i>(In thousands except per share data)</i>				
<b>Basic Earnings Per Share Calculation:</b>				
<b>Numerator</b>				
Net Income	\$ 108,446	\$ 89,504	\$ 304,878	\$ 252,815
<b>Denominator</b>				
Weighted average shares outstanding	63,605	62,491	63,319	62,511
<b>Earnings Per Share</b>	\$ 1.70	\$ 1.43	\$ 4.81	\$ 4.04
<b>Earnings Per Share Assuming Full Dilution Calculation:</b>				
<b>Numerator</b>				
Net Income	\$ 108,446	\$ 89,504	\$ 304,878	\$ 252,815
Interest expense on zero coupon convertible subordinated debentures, net of tax	464	475	1,409	1,415
Adjusted Net Income	\$ 108,910	\$ 89,979	\$ 306,287	\$ 254,230
<b>Denominator</b>				
Weighted average shares outstanding	63,605	62,491	63,319	62,511
Net effect of dilutive stock options	1,370	1,169	1,196	946
Assumed conversion of zero coupon convertible subordinated debentures	1,481	1,481	1,481	1,481
Fully diluted weighted average shares outstanding	66,456	65,141	65,996	64,938
<b>Earnings Per Share Assuming Full Dilution</b>	\$ 1.64	\$ 1.38	\$ 4.64	\$ 3.91

6. Comprehensive Income

The following summarizes comprehensive income reclassification adjustments for the nine months ended September 30, 2001, included in the statement of changes in stockholders' equity:

<i>(In thousands)</i>	September 30, 2001
<i>Investment Securities:</i>	
Holding gain on investment securities arising during the period (net of tax expense of \$18,008)	\$ 28,167
Reclassification adjustment for realized loss on investment securities (net of tax benefit of \$690)	(1,080)
	27,087
<i>Fair Value Hedges:</i>	
Holding loss related to foreign exchange transactions (net of tax benefit of \$625)	(978)
Transition adjustment (net of tax expense of \$167)	262
Reclassification adjustment related to foreign exchange gain on investment securities (net of tax expense of \$290)	454
	(262)
<i>Cash Flow Hedges:</i>	
Holding loss related to swap transactions (net of tax benefit of \$3,484)	(5,450)
Transition adjustment (net of tax benefit of \$2,710)	(4,239)
	(9,689)
Net gain recognized in other comprehensive income (net of tax expense of \$10,956)	\$ 17,136

7. Contingencies

From time to time in the ordinary course of business, the Company and certain of its subsidiaries are parties to various legal proceedings, many of which involve claims for coverage. The Company, like HMOs and health insurers generally, excludes certain health care services from coverage under its HMO, PPO and other plans. The Company is, in its ordinary course of business, subject to the claims of its enrollees arising out of decisions to restrict reimbursement for certain services. The loss of even one such claim, if it results in a significant punitive damage award, could have a material adverse effect on the Company. In addition, the risk of potential liability under punitive damage theories may increase significantly the difficulty of obtaining reasonable settlements of coverage claims.

In June 2000, the California Medical Association filed a lawsuit in U.S. district court in San Francisco against the Company's subsidiary, Blue Cross of California ("BCC"). The lawsuit alleges that BCC violated the federal Racketeering Influenced and Corrupt Organizations ("RICO") Act through various misrepresentations to and inappropriate actions against health care providers. In late 1999, a number of class-action lawsuits were brought against several of the Company's competitors alleging, among other things, various misrepresentations regarding their health plans and breaches of fiduciary obligations to health plan members. In August 2000, the Company was added as a party to *Shane v. Humana, et al.*, a class-action lawsuit brought on behalf of health care providers nationwide. In addition

to the RICO claims brought in the California Medical Association lawsuit, this lawsuit also alleges violations of ERISA, federal and state "prompt pay" regulations and certain common law claims. In October 2000, the federal Judicial Panel on Multidistrict Litigation issued an order consolidating the California Medical Association lawsuit, the *Shane* lawsuit and various other pending managed care class-action lawsuits against other companies before District Court Judge Federico Moreno in the Southern District of Florida for purposes of the pretrial proceedings. In March 2001, Judge Moreno dismissed the plaintiffs' claims based on violation of the RICO Act, although the dismissal was made without prejudice to the plaintiffs' ability to subsequently refile their claims. Judge Moreno also dismissed, with prejudice, the plaintiffs' federal prompt pay law claims. On March 26, 2001, the California Medical Association filed an amended complaint in its lawsuit, alleging, among other things, revised RICO claims and violations of California law. A hearing on the plaintiffs' motion to certify a class was held in early May 2001. On May 9, 2001, Judge Moreno issued an order requiring that all discovery in the litigation be completed by December 2001, with the exception of discovery related to expert witnesses, which must be completed by March 15, 2002. In June 2001, the federal Court of Appeals for the 11<sup>th</sup> Circuit issued a stay of Judge Moreno's discovery order, pending a hearing before the Court of Appeals on the Company's appeal of its motion to compel arbitration (which had earlier been granted in part and denied in part by Judge Moreno). The financial and operational impact that these and other evolving theories of recovery will have on the managed care industry generally, or the Company in particular, is at present unknown.

Certain of such legal proceedings are or may be covered under insurance policies or indemnification agreements. Based upon information presently available, management of the Company believes that the final outcome of all such proceedings should not have a material adverse effect on the Company's results of operations, cash flows or financial condition.

## 8. Business Segment Information

The Company currently has two reportable segments: the Large Employer Group business segment and the Individual and Small Employer Group business segment. The Large Employer Group and Individual and Small Employer Group segments provide a broad spectrum of network-based health plans, including HMOs, PPOs, POS plans, other hybrid plans and traditional indemnity products to large and small employers and individuals. The Company's senior and specialty businesses are included in the Corporate and Other segment. The acquired Cerulean business information has been integrated into the aforementioned customer segments.

The following tables present segment information for the Large Employer Group and Individual and Small Employer Group for the quarter and nine months ended September 30, 2001 and 2000, respectively.

Quarter Ended September 30, 2001

	Large Employer Group	Individual and Small Employer Group	Corporate and Other	Consolidated
<i>(In thousands)</i>				
Premium revenue	\$ 1,883,228	\$ 923,834	\$ 218,122	\$ 3,025,184
Management services revenue	129,325	25	26,841	156,191
Total revenue from external customers	2,012,553	923,859	244,963	3,181,375
Intercompany revenues	4,665	—	(4,665)	—
Segment net income	\$ 77,005	\$ 25,205	\$ 6,236	\$ 108,446
Segment assets	\$ 3,622,953	\$ 1,341,221	\$ 2,258,764	\$ 7,222,938

Quarter Ended September 30, 2000

	Large Employer Group	Individual and Small Employer Group	Corporate and Other	Consolidated
<i>(In thousands)</i>				
Premium revenue	\$ 1,283,463	\$ 762,719	\$ 138,457	\$ 2,184,639
Management services revenue	95,444	622	19,310	115,376
Total revenue from external customers	1,378,907	763,341	157,767	2,300,015
Intercompany revenues	13,035	5,517	(18,552)	—
Segment net income	\$ 70,540	\$ 45,982	\$ (27,018)	\$ 89,504
Segment assets	\$ 2,193,392	\$ 1,024,479	\$ 1,952,789	\$ 5,170,660

Nine Months Ended September 30, 2001

	Large Employer Group	Individual and Small Employer Group	Corporate and Other	Consolidated
<i>(In thousands)</i>				
Premium revenue	\$ 5,243,918	\$ 2,563,724	\$ 576,737	\$ 8,384,379
Management services revenue	366,210	260	77,736	444,206
Total revenue from external customers	5,610,128	2,563,984	654,473	8,828,585
Intercompany revenues	14,846	—	(14,846)	—
Segment net income	\$ 254,445	\$ 91,513	\$ (41,080)	\$ 304,878



Nine Months Ended September 30, 2000

	Large Employer Group	Individual and Small Employer Group	Corporate and Other	Consolidated
<i>(In thousands)</i>				
Premium revenue	\$ 3,665,111	\$ 2,243,055	\$ 399,580	\$ 6,307,746
Management services revenue	282,223	2,280	52,216	336,719
Total revenue from external customers	3,947,334	2,245,335	451,796	6,644,465
Intercompany revenues	8,447	6,017	(14,464)	—
Segment net income	\$ 183,992	\$ 138,304	\$ (69,481)	\$ 252,815

## 9. Hedging Activities

In June 1998, the Financial Accounting Standards Board (the "FASB") issued Statement of Financial Accounting Standards No. 133, "Accounting for Derivative Instruments and Hedging Activities" ("SFAS No. 133"). SFAS No. 133, as amended by SFAS Nos. 137 and 138, establishes the accounting and reporting standards for derivative instruments and for hedging activities. Upon adoption of SFAS No. 133, all derivatives must be recognized on the balance sheet at their then fair value. Any deferred gains and losses remaining on the balance sheet under previous hedge-accounting rules must be removed from the balance sheet and all hedging relationships must be designated anew and documented pursuant to the new accounting. The Company adopted SFAS No. 133 on January 1, 2001.

The Company maintains an interest rate risk management strategy that uses derivative instruments to minimize significant, unanticipated earnings fluctuations caused by interest rate volatility. The Company's goal is to maintain a balance between fixed and floating interest rates on its long term debt.

By using derivative financial instruments to hedge exposures to changes in exchange rates and interest rates, the Company exposes itself to credit risk and market risk. Market risk is the adverse effect on the value of a financial instrument that results from a change in currency exchange rates or interest rates. The Company manages exposure to market risk associated with interest rate and foreign exchange contracts by establishing and monitoring parameters that limit the types and degree of market risk that may be undertaken.

The Company uses interest rate swap agreements and foreign currency contracts to manage interest rate and foreign currency exposures. The principal objective of such contracts is to minimize the risks and/or costs associated with financial and investing activities. The Company does not use derivative financial instruments for speculative purposes. The counterparties to these contractual arrangements are major financial institutions with which the Company also has other financial relationships. These counterparties expose the Company to credit loss in the event of non-performance. However, the Company does not anticipate non-performance by the other parties.

### *Fair Value Hedges*

As part of the Company's investment strategy to diversify its investment portfolio, the Company has invested in certain fixed maturity securities denominated in foreign currencies. In order to mitigate the foreign currency risk, the Company has entered into foreign currency derivative instruments. Gains and losses related to such instruments are recognized in the Company's income statement.

The transition provisions of SFAS No.133, state that any gain or loss previously reported in accumulated other comprehensive income on a derivative that hedged an available-for-sale security, together with the gain or loss on the related security shall be reclassified to earnings as a cumulative effect type adjustment of both net income and accumulated other comprehensive income. On January 1, 2001, the Company recorded a transition adjustment as a charge to other income of approximately \$0.3 million, net of tax, which represents a gain of \$2.0 million on the available-for-sale bonds related to the Company's foreign exchange contracts partially offset by a loss of \$1.7 million on the related hedges.

For the nine months ended September 30, 2001, the Company recognized a net loss of \$0.6 million, included in other income on the consolidated income statement, which represented the ineffective portion of all the Company's fair value hedges. All components of each derivative's gain or loss were included in the assessment of hedge effectiveness.

### *Cash Flow Hedges*

The Company uses interest rate swap agreements to reduce the impact of changes in interest rates on its floating rate debt under its revolving credit facility. The swap agreements are contracts to exchange variable-rate for fixed-rate interest payments without the exchange of the underlying notional

amounts. During the nine months ended September 30, 2001, the Company recognized a net loss of \$0.1 million reported in other income in the consolidated income statement, which represents the total ineffectiveness of all cash flow hedges.

The adoption of SFAS No. 133 resulted in an after-tax reduction in accumulated other comprehensive income of \$4.2 million to recognize at fair value all derivatives that were designated as cash flow hedges as of January 1, 2001.

Events that are expected to occur over the next 12 months and will necessitate reclassifying the derivative losses into earnings relate primarily to the repricing of variable rate debt. The Company does not expect that the amounts that will be reclassified will be material to the Company's financial condition or results of operations.

As of September 30, 2001 the Company had the following interest rate swap agreements in effect (notional amount in thousands):

Notional Amount	Strike Rate	Expiration Date
\$ 150,000	6.99 %	October 17, 2003
\$ 50,000	7.06 %	October 17, 2006

As of September 30, 2001, the Company had recognized net derivative liabilities of \$17.8 million.

10. New Pronouncements

In June 2001, the Financial Accounting Standards Board (the "FASB") issued Statement of Financial Accounting Standards No. 141, "Business Combinations" ("SFAS No. 141"). SFAS No. 141 addresses financial accounting and reporting for business combinations and supersedes APB Opinion No. 16, "Business Combinations," and FASB Statement No. 38, "Accounting for Preacquisition Contingencies of Purchased Enterprises." Upon adoption of SFAS No. 141, all business combinations must be accounted for using the purchase method. The use of the pooling of interests method is now prohibited. The provisions of the new standard apply to all business combinations initiated after June 30, 2001. Based upon the Company's review of its operations conducted thus far, the Company does not expect that SFAS No. 141 will have a material effect on the financial statements of the Company.

In June 2001, the FASB issued Statement of Financial Accounting Standards No. 142, "Goodwill and Other Intangible Assets" ("SFAS No. 142"). SFAS No. 142 addresses financial accounting and reporting for acquired goodwill and other intangible assets and supersedes APB Opinion No. 17, "Intangible Assets." The new rules change the accounting methodology for goodwill from a model that amortizes goodwill to one which evaluates it for impairment. Amortization of goodwill, including previously recorded goodwill, will end upon adoption of the new rules. The new rules also eliminate amortization of other intangibles with indefinite useful lives, but these assets also will be subject to the impairment tests. SFAS 142 is effective for fiscal years beginning after December 15, 2001. Based upon the Company's review of its operations conducted thus far, the accounting impact of SFAS 142 related to goodwill amortization would increase the Company's net income by \$36 million on an annual basis. The Company is currently assessing the effects the other provisions of the new standard will have on its financial statements.

In June 2001, the FASB issued Statement of Financial Accounting Standards No. 143, "Accounting for Asset Retirement Obligations" ("SFAS No. 143"). SFAS No. 143 is effective for financial statements issued for fiscal years beginning after June 15, 2002. The Company will adopt SFAS No. 143 on January 1, 2003. The provisions of SFAS No. 143 require companies to record an asset and related liability for the costs associated with the retirement of a long-lived tangible asset if a legal liability to retire the asset exists. The Company is in the process of analyzing the provisions of SFAS No. 143;

however, the effect of adoption is not expected to have a significant impact on the Company's financial condition and results of operations.

In October 2001, the FASB issued Statement of Financial Accounting Standards No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" ("SFAS No. 144"). SFAS No. 144 is effective for financial statements issued for fiscal years beginning after December 15, 2001. The Company plans to adopt SFAS No. 144 on January 1, 2002. This statement addresses financial accounting and reporting for the impairment or disposal of long-lived assets and supersedes SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed of" and the accounting and reporting provisions of APB Opinion No. 30, "Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business and Extraordinary, Unusual, and Infrequently Occurring Events and Transactions," for the disposal of a segment of business (as previously defined in that opinion). SFAS No. 144 retains the basic principles of SFAS No. 121 for long-lived assets to be disposed of by sale or held and used and broadens discontinued operations presentation to include a component of an entity that is held for sale or that has been disposed. Components must have operations and cash flows that can be clearly distinguished from the rest of the entity. The Company is in the process of analyzing the provisions of this statement.

## **11. Pending Transactions**

On October 17, 2001, the Company entered into a definitive agreement with RightCHOICE Managed Care Inc. ("RightCHOICE") to merge in a transaction valued at \$1.3 billion, or \$66 per share, for RightCHOICE common stock. Upon completion of this transaction (the "Merger"), RightCHOICE will merge with a wholly owned subsidiary of WellPoint. RightCHOICE serves 2.8 million members and is the largest managed-care company in Missouri. RightCHOICE does business in Missouri under the name Blue Cross and Blue Shield of Missouri and through its HealthLink subsidiary. HealthLink provides network rental, administrative services, workers' compensation and other non-underwritten health benefit programs to approximately 500,000 members in six neighboring states. At the effective time of the Merger, the stockholders of RightCHOICE will receive for each share of RightCHOICE Common Stock either \$66 in cash or 0.6161 shares of WellPoint Common Stock. RightCHOICE stockholders will be able to elect to receive cash or WellPoint Common Stock for any or all of their shares of RightCHOICE Common Stock, subject to a prorationing mechanism which will provide that 70% of the outstanding RightCHOICE Common Stock will be converted into the right to receive WellPoint Common Stock and 30% of the outstanding RightCHOICE Common Stock will be converted into the right to receive cash. The transaction is intended to qualify as a tax-free transaction for RightCHOICE stockholders that elect to receive WellPoint Common Stock. The transaction is subject to a number of closing conditions including a vote of the RightCHOICE stockholders, approval by the Missouri and Illinois Departments of Insurance and approval by the Blue Cross Blue Shield Association. Approval by the RightCHOICE stockholders is relatively certain because the Missouri Foundation for Health (the "Foundation"), which owns approximately 57% of the outstanding RightCHOICE Common Stock, has entered into a Voting and Lockup Agreement with WellPoint, obligating the Foundation to vote in favor of the Merger (subject to certain exceptions). The Company currently expects the transaction to close during the quarter ending March 31, 2002.

## **ITEM 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

This discussion contains forward-looking statements, which involve risks and uncertainties. The Company's actual results may differ materially from those anticipated in these forward-looking statements as a result of certain factors including, but not limited to, those set forth under "Factors That May Affect Future Results of Operations."

## ***General***

The Company is one of the nation's largest publicly traded managed health care companies. As of September 30, 2001, WellPoint had approximately 10.0 million medical members and approximately 44.3 million specialty members. As a result of the March 15, 2001 closing of the Cerulean transaction, the Company's medical membership increased by approximately 1.9 million members. The Company offers a broad spectrum of network-based managed care plans. WellPoint provides these plans to the large and small employer, individual and senior markets. The Company's managed care plans include HMOs, PPOs, POS plans, other hybrid medical plans and traditional indemnity plans. In addition, the Company offers managed care services, including underwriting, actuarial services, network access, medical cost management and claims processing. The Company also provides a broad array of specialty and other products, including pharmacy, dental, utilization management, life insurance, preventive care, disability insurance, behavioral health, COBRA and flexible benefits account administration. The Company markets its products in California primarily under the name Blue Cross of California, in Georgia primarily under the name Blue Cross Blue Shield of Georgia and in other states primarily under the name UNICARE. Historically, the Company's primary market for managed care products has been California. The Company holds the exclusive right to market its products under the Blue Cross name and mark in California and under the Blue Cross Blue Shield name and mark in Georgia.

## ***National Expansion and Other Recent Developments***

In an effort to pursue the expansion of the Company's business outside the state of California, the Company acquired two businesses in 1996 and 1997, the Life and Health Benefits Management Division ("MMHD") of Massachusetts Mutual Life Insurance Company and the Group Benefits Operations (the "GBO") of John Hancock Mutual Life Insurance Company. The Cerulean, Rush Prudential and PrecisionRx acquisitions described below are each components of this expansion strategy.

As a result of these acquisitions, the Company has significantly expanded its operations outside of California. In order to integrate its acquired businesses and implement the Company's regional expansion strategy, the Company in certain instances will need to develop satisfactory networks of hospitals, physicians and other health care service providers, develop distribution channels for its products and successfully convert acquired books of business to the Company's existing information systems, which will require continued investments by the Company.

In January 2001, the Company introduced new benefit plans (known as PlanScape) to all of its individual PPO members in California. All of the Company's existing individual PPO plans in California were converted into newly designed plans, offering an array of premium levels, deductibles, cost sharing features and out-of-pocket limits. These plan changes did not affect any of the Company's PPO plans under employer-sponsored arrangements.

In response to rising medical and pharmacy costs, the Company has from time to time implemented premium increases with respect to certain of its products. The Company will continue to evaluate the need for further premium increases, plan design changes and other appropriate actions in the future in order to maintain or restore profit margins. There can be no assurances, however, that the Company will be able to take subsequent pricing or other actions or that any actions previously taken or implemented in the future will be successful in addressing any concerns that may arise with respect to the performance of certain businesses.

## ***Acquisition of Cerulean***

On July 9, 1998, the Company entered into an Agreement and Plan of Merger with Cerulean Companies, Inc. ("Cerulean") (See Note 3 to the Consolidated Financial Statements). On March 15, 2001, the Company completed this transaction, pursuant to which Cerulean has become a wholly owned

subsidiary of the Company. The transaction, which was financed with cash from operations and debt from the Company's existing revolving credit facility, is valued at approximately \$700.0 million, excluding deferred taxes and assumed liabilities. Cerulean, principally through its Blue Cross and Blue Shield of Georgia subsidiary, offers insured and administrative services products primarily in the State of Georgia. Cerulean has historically experienced a higher administrative expense ratio than the Company's core businesses due to its higher concentration of administrative services business. Cerulean has also historically experienced a higher medical loss ratio than the Company's core businesses due to its higher percentage of Large Employer Group business and fewer managed care offerings. Accordingly, it is expected that Cerulean's higher loss and administrative expense ratios will contribute to an increase in those ratios for the Company.

#### *Acquisition of PrecisionRx*

On December 5, 2000, the Company completed its acquisition of a mail order pharmacy fulfillment facility (See Note 3 to the Consolidated Financial Statements). The facility, located in Fort Worth Texas, now operates under the new name of PrecisionRx. The acquisition was accounted for under the purchase method of accounting.

#### *Acquisition of Rush Prudential*

On March 1, 2000, the Company completed its acquisition of Rush Prudential Health Plans ("Rush Prudential") (See Note 3 to the Consolidated Financial Statements). Rush Prudential offers a broad array of products and services ranging from HMO products to traditional PPO products and has been primarily integrated into the Company's existing Large Employer Group business. Rush Prudential historically experienced a higher loss ratio than the Company's core business, which may result in an increase in the Company's overall loss ratio. The acquisition had significantly increased the Company's Illinois medical membership to nearly 600,000 members as of March 31, 2000. Subsequent to the acquisition, the acquired business has been operated as UNICARE Health Plans. The transaction, which was financed with cash from operations and debt from the Company's existing revolving credit facility, is valued at approximately \$202.6 million, subject to certain post-closing adjustments. This acquisition was accounted for under the purchase method of accounting.

#### *Federal "Patients' Bill of Rights" Legislation*

In June 2001, the United States Senate passed a bill that would enact a number of health care reforms (often referred to as the "Patients' Bill of Rights"). The Senate bill includes a number of provisions generally expanding the rights of health care plan members, such as requiring health plans to allow direct access to obstetrician/gynecologists and pediatricians and provide timely access to appropriate specialists, the adoption of a "prudent layperson" standard for emergency visits by members and the establishment of an independent medical review process. In addition, the bill would create liability for any group health plan fiduciary that fails to exercise ordinary care in making any non-medically reviewable decisions regarding, among other things, covered services, exclusions and limitations, where such decision is the proximate cause of personal injury or death. The Senate bill would allow members to sue in state or federal court after exhausting independent review procedures (regardless of whether the health plan's original decision is upheld). Unlimited damages would be available in state court actions (unless state law provides for a maximum amount), while punitive damages amounts in federal courts would be limited to a maximum of \$5 million. Employers would be able to limit liability in certain instances by naming a "designated decision maker." In August 2001, the United States House of Representatives also adopted a bill that would provide for a number of health care reform measures. The provisions providing patient protections are similar to those contained in the Senate version of the bill. The House bill also includes a liability provision. Under the House bill, non-economic damages (including punitive damages) in federal court actions would be limited to

\$1.5 million and individual states would be permitted to apply lower maximums in state court actions. In addition, punitive damages would only be available if a health plan failed to comply with the decision of an independent medical reviewer. The Senate bill would not affect existing state laws that meet or exceed the proposed federal standards, while the House bill would preempt all state laws in certain instances. The Company is unable to determine which federal health care reform legislation, if any, will be adopted this year or in the future. While the Company's operations in California, Georgia and Texas are already subject to state laws that have features similar to the proposed federal legislation, any such federal legislation could have a material adverse effect on the Company's results of operations, financial condition or cash flows.

#### *Other Legislation*

Federal legislation enacted during the last five years seeks, among other things, to insure the portability of health coverage and mandates minimum maternity hospital stays. California legislation enacted since 1999, among other things, establishes an explicit duty on managed care entities to exercise ordinary care in arranging for the provision of medically necessary health care services and establishes a system of independent medical review. In 1997, Texas adopted legislation purporting to make managed care organizations such as the Company liable for their failure to exercise ordinary care when making health care treatment decisions. Similar legislation has also been enacted in Georgia. These and other proposed measures may have the effect of dramatically altering the regulation of health care and of increasing the Company's loss ratio and administrative costs or decreasing the affordability of the Company's products.

#### *Consolidated Results of Operations*

The Company's revenues are primarily generated from premiums earned for risk-based health care and specialty services provided to its members, fees for administrative services, including claims processing and access to provider networks for self-insured employers, and investment income. Operating expenses include health care services and other benefits expenses, consisting primarily of payments for physicians, hospitals and other providers for health care and specialty products claims; selling expenses for broker and agent commissions; general and administrative expenses; interest expense; depreciation and amortization expense; and income taxes.

The Company's results of operations for the quarter ended September 30, 2001 include a full quarter of earnings for its acquired operations, Rush Prudential, PrecisionRx and Cerulean. The Company's consolidated results of operations for the nine months ended September 30, 2001 include a full nine months of earnings for Rush Prudential, PrecisionRx and approximately six and a half months of earnings for Cerulean. The results of operations for the quarter ended September 30, 2000 include a full quarter of earnings for Rush Prudential and the results of operations for the nine months ended September 30, 2000 include the results of Rush Prudential for the period from March 1, 2000, its date of acquisition.

The following table sets forth selected operating ratios. The loss ratio for health care services and other benefits is shown as a percentage of premium revenue. All other ratios are shown as a percentage of premium revenue and management services revenue combined.

	Quarter Ended September 30,		Nine Months Ended September 30,	
	2001	2000	2001	2000
Operating Revenues:				
Premium revenue	95.1 %	95.0 %	95.0 %	94.9 %
Management services revenue	4.9 %	5.0 %	5.0 %	5.1 %
	100.0 %	100.0 %	100.0 %	100.0 %
Operating Expenses:				
Health care services and other benefits (loss ratio)	81.7 %	80.7 %	81.4 %	80.8 %
Selling expense	4.0 %	4.4 %	4.1 %	4.4 %
General and administrative expense	13.5 %	14.1 %	13.8 %	14.0 %



Membership

The following table sets forth membership data and the percent change in membership:

Medical Membership (a) (b) (c):

	As of September 30,		Percent
	2001	2000	Change
Large Employer Group (d)			
California			
HMO	1,918,297	1,759,805	9.0%
PPO and Other	2,125,406	1,923,421	10.5%
Total California	4,043,703	3,683,226	9.8%
Texas	204,802	194,765	5.2%
Georgia	1,521,551	42,705	3,462.9%
Illinois	437,740	462,516	-5.4%
Other States	1,218,548	1,196,114	1.9%
Total Large Employer Group	7,426,344	5,579,326	33.1%
Individual and Small Employer Group			
California			
HMO	323,369	350,695	-7.8%
PPO and Other	1,253,923	1,221,393	2.7%
Total California	1,577,292	1,572,088	0.3%
Texas	170,933	171,382	-0.3%
Georgia	333,069	31,259	965.5%
Illinois	83,449	62,111	34.4%
Other States	83,145	99,514	-16.4%
Total Individual and Small Employer Group	2,247,888	1,936,354	16.1%
Senior (e)			
California			
HMO	35,297	34,247	3.1%
PPO and Other	179,054	172,623	3.7%
Total California	214,351	206,870	3.6%
Texas	321	228	40.8%
Georgia	74,882	915	8,083.8%
Illinois	11,827	10,047	17.7%
Other States	17,151	9,233	85.8%
Total Senior	318,532	227,293	40.1%
Total Medical Membership	9,992,764	7,742,973	29.1%
Membership by Network (f)			
Proprietary Networks	7,856,003	6,016,295	30.6%
Affiliate Networks	1,318,843	1,083,485	21.7%
Non-Network	817,918	643,193	27.2%
Total Medical Membership	9,992,764	7,742,973	29.1%
Management Services Membership			
California	1,376,364	1,272,171	8.2%
Georgia	889,950	24,419	3544.5%
Other States	1,172,624	1,222,317	-4.1%
Total Management Services Membership	3,438,938	2,518,907	36.5%



- (a) Membership numbers are approximate and include some estimates based upon the number of contracts at the relevant date and an actuarial estimate of the number of members represented by the contract.
- (b) Classification between states for employer groups is determined by the zip code of the subscriber.
- (c) Medical membership includes management services members, which are primarily included in the Large Employer Group segment.
- (d) Large Employer Group membership includes 984,431 and 788,505 state-sponsored programs members as of September 30, 2001 and 2000, respectively.
- (e) Senior membership includes members covered under both Medicare risk and Medicare supplement products.
- (f) Proprietary networks consist of California, Georgia, Texas and other WellPoint-developed or WellPoint-controlled networks. Affiliate networks consist of third-party networks that incorporate provider discounts and some basic managed care elements. Non-network consists of fee for service and percentage-of-billed charges contracts with providers. Membership in both periods shown reflects a restatement to include in proprietary network membership members of WellPoint-controlled networks which were previously reflected as affiliate network members.

**Specialty Membership**

	As of September 30,		Percent Change
	2001	2000	
Pharmacy	31,925,513	27,808,491	14.8 %
Dental	2,642,554	2,223,482	18.8 %
Utilization Management	1,798,896	2,114,175	-14.9 %
Life	2,299,043	1,992,818	15.4 %
Disability	545,625	561,146	-2.8 %
Behavioral Health (a)	5,094,286	3,274,074	55.6 %

- (a) Behavioral health membership as of September 30, 2001 reflects a net addition of 2,046,812 members over September 30, 2000 due to the mental health parity requirements in the State of California, which became effective in the third quarter of 2000. The increase in membership associated with this new law was incremental from the third quarter of 2000 to the second quarter of 2001 depending upon the re-enrollment date or re-pricing date of each contract.

Comparison of Results for the Quarter Ended September 30, 2001 to the Quarter Ended September 30, 2000

The following table depicts premium revenue by business segment:

(In thousands)	Quarter Ended September 30,	
	2001	2000
Large Employer Group	\$ 1,883,228	\$ 1,283,463
Individual and Small Employer Group	923,834	762,719
Corporate and Other	218,122	138,457
Consolidated	\$ 3,025,184	\$ 2,184,639

Premium revenue increased 38.5%, or \$840.6 million, to \$3,025.2 million for the quarter ended September 30, 2001 from \$2,184.6 million for the quarter ended September 30, 2000. The increase was primarily due to \$576.3 million of premium revenue related to the Cerulean acquisition, representing 68.6% of the increase. Excluding Cerulean, premium revenue would have increased 12.1% for the quarter ended September 30, 2001. The increase excluding Cerulean was primarily due to an increase in insured member months of approximately 4.8% primarily in the Large Employer Group business segment, and the implementation of price increases overall, partially offset by a slight decline in insured member months in the Individual and Small Employer Group business segment.

The following table depicts management services revenue by business segment:

(In thousands)	Quarter Ended September 30,	
	2001	2000
Large Employer Group	\$ 129,325	\$ 95,444
Individual and Small Employer Group	25	622
Corporate and Other	26,841	19,310
Consolidated	\$ 156,191	\$ 115,376

Management services revenue increased 35.4%, or \$40.8 million, to \$156.2 million for the quarter ended September 30, 2001 from \$115.4 million for the quarter ended September 30, 2000. The increase was primarily due to \$38.6 million of management services revenue from the Cerulean acquisition, representing 94.6% of the increase. Excluding Cerulean, management services revenue would have increased 1.9% for the quarter ended September 30, 2001.

Investment income was \$64.1 million the quarter ended September 30, 2001 compared to \$53.3 million for the quarter ended September 30, 2000, an increase of \$10.8 million or 20.3%. The Cerulean acquisition accounted for \$6.3 million of the increase. Excluding Cerulean, investment income would have increased \$4.5 million or 8.4%. The increase excluding Cerulean was primarily due to net interest and dividend income, which increased \$2.6 million to \$53.8 million for the quarter ended September 30, 2001 in comparison to \$51.2 million for the quarter ended September 30, 2000. This increase resulted from higher average investment balances in the third quarter of 2001 versus the third quarter of 2000.

The loss ratio attributable to managed care and related products for the quarter ended September 30, 2001 increased to 81.7% compared to 80.7% for the quarter ended September 30, 2000. The acquired Cerulean business has traditionally experienced a higher loss ratio than the Company's core businesses due to its higher percentage of Large Employer Group business and fewer managed care offerings. Excluding Cerulean, the loss ratio increased slightly to 80.9% for the quarter ended September 30, 2001.

Selling expense consists of commissions paid to outside brokers and agents representing the Company. The selling expense ratio for the quarter ended September 30, 2001 decreased to 4.0% compared to 4.4% for the quarter ended September 30, 2000. The acquired Cerulean business has traditionally experienced a lower selling expense ratio due primarily to its lower percentage of Individual and Small Employer Group business. Excluding Cerulean, the selling expense ratio would have remained unchanged at 4.4% for the quarter ended September 30, 2001.

The administrative expense ratio decreased to 13.5% for the quarter ended September 30, 2001 from 14.1% for the quarter ended September 30, 2000. The acquired Cerulean business has historically experienced a higher administrative expense ratio than the Company's core businesses due to its higher percentage of administrative services business. Excluding Cerulean, the administrative expense ratio would have been 13.3% for the quarter ended September 30, 2001. The lower administrative expense ratio in the third quarter 2001, excluding Cerulean, is primarily attributable to savings from the integration of information systems centers related to acquired businesses onto the Company's information systems platform, economies of scale associated with premium revenue growth in relation to fixed corporate administrative expenses in addition to technology investments made by the Company (e.g., electronic claims submission, internet self-service and interactive voice response).

Interest expense increased \$8.9 million to \$14.6 million for the quarter ended September 30, 2001, compared to \$5.7 million for the quarter ended September 30, 2000. The increase in interest expense was related to the higher average debt balance for the quarter ended September 30, 2001 in comparison to the quarter ended September 30, 2000, primarily due to the Cerulean acquisition. The weighted average interest rate for all debt for the quarter ended September 30, 2001, including the fees associated with the Company's borrowings and interest rate swap agreements, was 6.04%.

The Company's net income for the quarter ended September 30, 2001 was \$108.4 million, compared to \$89.5 million for the quarter ended September 30, 2000. Earnings per share totaled \$1.70 and \$1.43 for the quarter ended September 30, 2001 and 2000, respectively. Earnings per share assuming full dilution totaled \$1.64 and \$1.38 for the quarter ended September 30, 2001 and 2000, respectively.

Earnings per share for the quarter ended September 30, 2001 is based upon weighted average shares outstanding of 63.6 million shares, excluding potential common stock, and 66.5 million shares, assuming full dilution. Earnings per share for the quarter ended September 30, 2000 is based on 62.5 million shares, excluding potential common stock, and 65.1 million shares, assuming full dilution. The increase in weighted average shares outstanding primarily resulted from the issuance of shares related to the Company's employee stock option and purchase plans.

**Comparison of Results for the Nine Months Ended September 30, 2001 to the Nine Months Ended September 30, 2000**

The following table depicts premium revenue by business segment:

(In thousands)	Nine Months Ended September 30,	
	2001	2000
Large Employer Group	\$ 5,243,918	\$ 3,665,111
Individual and Small Employer Group	2,563,724	2,243,055
Other	576,737	399,580
Consolidated	\$ 8,384,379	\$ 6,307,746

Premium revenue increased 32.9%, or \$2,076.7 million, to \$8,384.4 million for the nine months ended September 30, 2001 from \$6,307.7 million for the nine months ended September 30, 2000. The

increase was primarily due to \$1,297.2 million of premium revenue related to the Cerulean and Rush Prudential acquisitions, representing 62.5% of the increase. Excluding acquisitions, premium revenue would have increased 12.4% for the nine months ended September 30, 2001. The increase excluding acquisitions was primarily due to an increase in insured member months of approximately 7.0% primarily in the Large Employer Group business segment, and the implementation of price increases overall.

The following table depicts management services revenue by business segment:

(In thousands)	Nine Months Ended September 30,	
	2001	2000
Large Employer Group	\$ 366,210	\$ 282,223
Individual and Small Employer Group	260	2,280
Other	77,736	52,216
Consolidated	\$ 444,206	\$ 336,719

Management services revenue increased 31.9%, or \$107.5 million, to \$444.2 million for the nine months ended September 30, 2001 from \$336.7 million for the nine months ended September 30, 2000. The increase was primarily due to \$85.6 million of management services revenue related to the Cerulean and Rush Prudential acquisitions, representing 79.6% of the increase. Excluding acquisitions, management services revenue would have increased 6.5% for the nine months ended September 30, 2001. The increase excluding acquisitions was primarily due to an increase in pharmacy benefit management services revenues.

Investment income was \$177.7 million for the nine months ended September 30, 2001 compared to \$142.9 million for the nine months ended September 30, 2000, an increase of \$34.8 million or 24.4%. The Cerulean and Rush Prudential acquisitions represented \$16.0 million, or 46.0%, of the increase. Excluding acquisitions, investment income would have increased \$18.8 million or 13.2%. The increase excluding acquisitions was primarily due to net interest and dividend income, which increased \$12.7 million to \$163.8 million for the nine months ended September 30, 2001 in comparison to \$151.1 million for the nine months ended September 30, 2000. This increase resulted from higher average investment balances during the nine months ended September 30, 2001 versus 2000. Additionally, an increase in net realized gains, excluding acquisitions, of \$7.0 million also contributed to the increase in net investment income. (See "—Liquidity and Capital Resources").

The loss ratio attributable to managed care and related products for the nine months ended September 30, 2001 increased to 81.4% compared to 80.8% for the nine months ended September 30, 2000. The acquired Cerulean business has traditionally experienced a higher loss ratio than the Company's core businesses due to its higher percentage of Large Employer Group business and fewer managed care offerings. Excluding the Cerulean and Rush Prudential acquisitions, the loss ratio would have remained unchanged at 80.8% for the nine months ended September 30, 2001.

The selling expense ratio for the nine months ended September 30, 2001 decreased to 4.1% compared to 4.4% for the nine months ended September 30, 2000. The acquired Cerulean business has traditionally experienced a lower selling expense ratio due primarily to its lower percentage of Individual and Small Employer Group business. Excluding the Cerulean and Rush Prudential acquisitions, the selling expense ratio would have remained unchanged for the nine months ended September 30, 2001.

The administrative expense ratio decreased slightly to 13.8% for the nine months ended September 30, 2001 from 14.0% for the nine months ended September 30, 2000. The acquired Cerulean and Rush Prudential acquisitions have historically experienced higher administrative expense

ratios than the Company's core businesses due to a higher percentage of administrative services business. Excluding acquisitions, the administrative expense ratio would have been 13.7%. The decline excluding acquisitions is primarily attributable to savings from the integration of information systems centers related to acquired businesses onto the Company's information systems platform, economies of scale associated with premium revenue growth in relation to fixed corporate administrative expenses in addition to technology investments made by the Company (e.g., electronic claims submission, internet self-service and interactive voice response).

Interest expense increased \$17.9 million for the nine months ended September 30, 2001 compared to the nine months ended September 30, 2000. The increase in interest expense was related to the higher average debt balance for the nine months ended September 30, 2001 in comparison to the nine months ended September 30, 2000, primarily due to the Cerulean acquisition. The weighted average interest rate for all debt for the nine months ended September 30, 2001, including the fees associated with the Company's borrowings and interest rate swap agreements, was 6.64%.

The Company's net income for the nine months ended September 30, 2001 was \$304.9 million, compared to \$252.8 million for the nine months ended September 30, 2000. Earnings per share totaled \$4.81 and \$4.04 for the nine months ended September 30, 2001 and 2000, respectively. Earnings per share assuming full dilution totaled \$4.64 and \$3.91 for the nine months ended September 30, 2001 and 2000, respectively.

Earnings per share for the nine months ended September 30, 2001 is based upon weighted average shares outstanding of 63.3 million, excluding potential common stock, and 66.0 million shares, assuming full dilution. Earnings per share for the nine months ended September 30, 2000 is based on 62.5 million shares, excluding potential common stock, and 64.9 million shares, assuming full dilution. The increase in weighted average shares outstanding primarily resulted from the issuance of shares related to the Company's employee stock option and purchase plans.

### ***Financial Condition***

The Company's consolidated assets increased by \$1,718.2 million, or 31.2%, from \$5,504.7 million as of December 31, 2000 to \$7,222.9 million as of September 30, 2001. The increase in total assets was primarily due to the acquisition of Cerulean, which accounted for \$1,073.9 million or 62.5% of the increase. Excluding Cerulean, the increase in total assets was primarily due to growth in cash and investments of \$503.6 million or 78.2%. Cash and investments totaled \$4.6 billion as of September 30, 2001, or 63.5% of total assets.

Overall claims liabilities increased \$214.0 million, or 11.3%, from \$1,892.2 million as of December 31, 2000 to \$2,106.2 million as of September 30, 2001. This increase is primarily due to the Cerulean acquisition.

As of September 30, 2001, the Company's long-term indebtedness was \$887.1 million, of which \$153.1 million was related to the Company's Zero Coupon Convertible Subordinated Debentures (the "Debentures"), \$285.0 million was related to the Company's revolving credit facility and \$449.0 million was related to the Company's 6<sup>3</sup>/<sub>8</sub> % Notes due 2006. (See Note 4 to the Consolidated Financial Statements). As a result of the Cerulean acquisition, the Company incurred \$500.0 million of indebtedness under its revolving credit facility. During the quarter ended June 30, 2001, the Company utilized the proceeds from the aforementioned 6<sup>3</sup>/<sub>8</sub> % Notes to reduce the outstanding balance of the Company's revolving credit facility. As of December 31, 2000, the Company's long-term indebtedness was \$400.9 million, of which \$250.0 million was related to the Company's revolving credit facility and \$150.9 million was related to the Debentures.

Stockholders' equity totaled \$2,023.4 million as of September 30, 2001, an increase of \$379.0 million from \$1,644.4 million as of December 31, 2000. The increase was primarily due to net

income of \$304.9 million for the nine months ended September 30, 2001 in addition to \$64.4 million of net proceeds from the reissuance of treasury stock related to the Company's employee stock option and purchase plans, in addition to an increase in other comprehensive income of \$17.1 million, primarily related to an increase in net unrealized gains on investment securities. (See Note 6 to the Consolidated Financial Statements). During the third quarter of 2001, the Company purchased 75,000 shares of its common stock which reduced the stockholders' equity by approximately \$7.4 million.

### ***Liquidity and Capital Resources***

The Company's primary sources of cash are premium and management services revenues received and investment income. The primary uses of cash include health care claims and other benefits, capitation payments, income taxes, repayment and repurchases of long-term debt, interest expense, broker and agent commissions, administrative expenses, common stock repurchases and capital expenditures. In addition to the foregoing, other uses of cash include costs of provider networks and systems development, and costs associated with the integration of acquired businesses.

The Company generally receives premium revenue in advance of anticipated claims for related health care services and other benefits. The Company's investment policies are designed to provide liquidity, preserve capital and maximize yield. Cash and investment balances maintained by the Company are sufficient to meet applicable regulatory financial stability and net worth requirements, including license requirements of the Blue Cross Blue Shield Association. As of September 30, 2001, the Company's investment portfolio consisted primarily of investment grade fixed-maturity securities.

Cash flow provided by operating activities was \$445.7 million for the nine months ended September 30, 2001, compared with \$386.9 million for the nine months ended September 30, 2000. Cash flow from operations for the nine months ended September 30, 2001 was due primarily to net income of \$304.9 million, increases in accounts payable and accrued expenses due to the timing of other operating liability payments and an increase in income tax payable. These items were partially offset by an increase in accounts receivable of \$119.3 million, which was primarily related to the timing of collection of large customer receivables in the normal course of business.

Net cash used in investing activities for the nine months ended September 30, 2001 totaled \$1,023.2 million, compared with \$415.0 million for the nine months ended September 30, 2000. The cash used in the first nine months of 2001 was attributable primarily to the purchase of investments of \$3.2 billion, property and equipment, net of sales proceeds of \$59.3 million and the purchase of Cerulean net of acquired cash of \$556.2 million. Proceeds from investments sold and matured totaled \$2.8 billion, partially offsetting the aforementioned purchases.

Net cash provided by financing activities totaled \$541.0 million in the first nine months of 2001 compared to net cash used in financing activities of \$68.0 million in the nine months ended September 30, 2000. The increase was primarily related to additional debt incurred to finance the Cerulean acquisition of \$500.0 million, in addition to the receipt of proceeds from the issuance of stock related to the Company's employee stock option and purchase programs of \$64.4 million.

Effective as of March 30, 2001, the Company entered into two new unsecured revolving credit facilities allowing aggregate indebtedness of \$1.0 billion. Upon execution of these facilities, the Company terminated its prior \$1.0 billion unsecured revolving facility. Borrowings under these facilities (which are generally referred to collectively in this Quarterly Report on Form 10-Q as the Company's "revolving credit facility") bear interest at rates determined by reference to the bank's base rate or to the London Inter Bank Offered Rate ("LIBOR") plus a margin determined by reference to the then-current rating of the Company's unsecured long-term debt by specified rating agencies. One facility, which provides for borrowings of up to \$750,000,000, expires as of March 30, 2006, although it may be extended for up to two additional one-year periods under certain circumstances. The other facility, which provides for borrowings of up to \$250,000,000, expires as of March 30, 2002. Any amount



outstanding under this facility as of March 30, 2002 may be converted into a one-year term loan at the option of the Company. Borrowings under the facilities are made on a committed basis or, in the case of the \$750.0 million facility, pursuant to an auction bid process. The \$750.0 million facility also contains sublimits for letters of credit and "swingline" loans. Each credit agreement requires the Company to maintain certain financial ratios and contains restrictive covenants, including restrictions on the occurrence of additional indebtedness and the granting of certain liens, limitations on acquisitions and investments and limitations on changes in control (See Note 4 to the Consolidated Financial Statements). The total amount outstanding under these facilities was \$285.0 million as of September 30, 2001. The total amount outstanding under the Company's prior revolving credit facility was \$250.0 million as of December 31, 2000.

As a part of a hedging strategy to limit its exposure to variable interest rate increases, the Company entered into interest rate swap agreements in order to reduce the volatility of interest expense resulting from changes in interest rates. The swap agreements are contracts to exchange variable-rate interest payments (weighted average rate for the nine months ended September 30, 2001 of 5.27%) for fixed-rate interest payments (weighted average rate for the nine months ended September 30, 2001 of 7.35%) without the exchange of the underlying notional amounts. As of September 30, 2001, the Company had entered into \$200.0 million of fixed rate swap agreements, which consisted of a \$150.0 million notional amount swap agreement at 6.99% maturing on October 17, 2003 and a \$50.0 million notional amount swap agreement at 7.06% maturing on October 17, 2006.

The Company has entered into foreign currency forward exchange contracts for each of the fixed maturity securities on hand as of September 30, 2001 denominated in foreign currencies in order to hedge asset positions with respect to currency fluctuations related to these securities. Subsequent to the implementation of SFAS No. 133, all gains and losses from both effective and ineffective forward exchange contracts will be reflected in investment income offset by the related gains and losses on the Company's available-for-sale foreign securities (See Note 9 to the Consolidated Financial Statements). In addition, the Company has entered into forward exchange contracts to hedge the foreign currency risk between the trade date and the settlement date when a foreign currency denominated bond is purchased. Gains and losses from these contracts are recognized in income.

Certain of the Company's subsidiaries are required to maintain minimum capital requirements prescribed by various regulatory agencies, including the California Department of Managed Health Care and the Departments of Insurance in various states. As of September 30, 2001 (or the most recent date with respect to which compliance is required), those subsidiaries of the Company were in compliance with all minimum capital requirements.

In July 1996, the Company filed a registration statement relating to the issuance of \$1.0 billion of senior or subordinated unsecured indebtedness. On June 15, 2001, the Company issued \$450.0 million aggregate principal amount at maturity of  $6\frac{3}{8}\%$  Notes due June 15, 2006 (the "Notes") under this registration statement. The net proceeds of this offering totaled approximately \$449.0 million. The net proceeds from the sale of the Notes were used for repayment of indebtedness under the Company's revolving credit facilities. The Notes bear interest at a rate of  $6\frac{3}{8}\%$  per annum, payable semi-annually in arrears on June 15 and December 15 of each year commencing December 15, 2001. Interest will be computed on the basis of a 360-day year of twelve 30-day months.

The Notes may be redeemed, in whole or in part, at the Company's option at any time. The redemption price for any Notes redeemed will be equal to the greater of the following amounts: 1) 100% of the principal amount of the Notes being redeemed on the redemption date; and 2) the sum of the present values of the remaining scheduled payments of principal and interest on the Notes being redeemed on that redemption date (not including any portion of any payments of interest accrued to the redemption date) discounted to the redemption date on a semiannual basis at the Treasury rate as determined by the Reference Treasury Dealer (Salomon Smith Barney Inc. or UBS Warburg LLC or

their respective successors), plus 25 basis points. In each case, the redemption price will also include accrued and unpaid interest on the Notes to the redemption date.

The Notes are unsecured obligations and rank equally with all of the Company's existing and future senior unsecured indebtedness. All existing and future liabilities of the Company's subsidiaries are and will be effectively senior to the Notes. The indenture governing the Notes contains a covenant that limits the Company's ability and that of the Company's subsidiaries to create liens on Company property or assets to secure certain indebtedness without also securing the Notes.

The Company currently expects that its pending merger with RightCHOICE will be consummated during the quarter ending March 31, 2002. In connection with the payment of the cash consideration for such transaction, the Company currently expects to incur debt of approximately \$300 million. The remaining cash consideration of approximately \$74.7 million will be funded from the Company's operating cash. (See also Note 11 of the Notes to the Consolidated Financial Statements and "Factors That May Affect Future Results of Operations.")

The Company believes that cash flow generated by operations and its cash and investment balances, supplemented by the Company's ability to borrow under its existing revolving credit facility or through public or private financing sources, will be sufficient to fund continuing operations and expected capital requirements for the foreseeable future.

### ***Factors That May Affect Future Results of Operations***

Certain statements contained herein, such as statements concerning potential or future loss ratios, pending acquisitions and other statements regarding matters that are not historical facts, are forward-looking statements (as such term is defined in the Securities Exchange Act of 1934). Such statements involve a number of risks and uncertainties that may cause actual results to differ from those projected. Factors that can cause actual results to differ materially include, but are not limited to, those discussed below and those discussed from time to time in the Company's various filings with the Securities and Exchange Commission, including the Company's Annual Report on Form 10-K.

The Company's operations are subject to substantial regulation by federal, state and local agencies in all jurisdictions in which the Company operates. Many of these agencies have increased their scrutiny of managed health care companies in recent periods or are expected to increase their scrutiny, as newly passed legislation becomes effective. From time to time, the Company and its subsidiaries receive requests for information from regulatory agencies or are notified that such agencies are conducting reviews, investigations or other proceedings with respect to certain of the Company's activities. The Company also provides insurance products to Medi-Cal beneficiaries in various California counties under contracts with the California Department of Health Services (or delegated local agencies) and provides administrative services to the Health Care Finance Administration ("HCFA") in various capacities. There can be no assurance that acting as a government contractor in these circumstances will not increase the risk of heightened scrutiny by such government agencies or that such scrutiny will not have a material adverse effect on the Company, either through negative publicity about the Company or through an adverse impact on the Company's results of operations. In addition, profitability from this business may be adversely affected through inadequate premium rate increases due to governmental budgetary issues. Future actions by any regulatory agencies may have a material adverse effect on the Company's business. See also "—General—Federal "Patients' Bill of Rights' Legislation."

Completion of the Company's pending transaction with RightCHOICE is contingent upon, among other things, receipt of necessary approvals from certain federal and state agencies on or before June 30, 2002. Broad latitude in administering the applicable regulations is given to the agencies from which WellPoint and RightCHOICE must seek these approvals. There can be no assurance that the Company will obtain these approvals. As a condition to approval of the transaction, regulatory agencies

may impose requirements or limitations or costs on the way that the combined company conducts business after consummation of the transaction. If the Company or RightCHOICE were to agree to any material requirements or limitations in order to obtain any necessary approvals, such requirements or limitations or additional costs could adversely affect the Company's ability to integrate the operations of RightCHOICE with those of the Company, and could result in a material adverse effect on the Company's revenues or results of operations.

The Company intends to incur debt to finance some or all of the cash payments to be made to RightCHOICE stockholders in connection with the pending acquisition. In addition, the Company has made significant purchases of treasury stock over the last three years and may in the future use excess cash as well as additional borrowings to repurchase the Company's Common Stock to offset shares issued in connection with the transaction. In March 2001, the Company incurred significant indebtedness to fund its acquisition of Cerulean. Upon completion of the merger with RightCHOICE, the Company could incur significant additional indebtedness to fund not only the cash portion of the transaction, but to fund any further repurchases of WellPoint Common Stock. This indebtedness may result in a significant percentage of the Company's cash flow being applied to the payment of interest, and there can be no assurance that the Company's operations will generate sufficient cash flow to service the indebtedness. This indebtedness, as well as any indebtedness the Company may incur in the future, may adversely affect the Company's ability to finance its operations and could limit its ability to pursue business opportunities that may be in the best interests of the Company and its stockholders.

As part of the Company's business strategy, the Company has acquired substantial operations in new geographic markets over the last five years. These businesses, some of which include substantial indemnity-based insurance operations, have experienced varying profitability or losses in recent periods. Since the relevant dates of acquisition of MMHD, GBO, Rush Prudential and Cerulean, the Company has continued to work extensively on the integration of these businesses. Upon completion of the RightCHOICE transaction, the Company intends to promptly begin integration of its business. However, there can be no assurances regarding the ultimate success of the Company's integration efforts or regarding the ability of the Company to maintain or improve the results of operations of the businesses of completed or pending transactions as the Company pursues its strategy of motivating the acquired members to select managed care products. In order to implement this business strategy, the Company has incurred and will, among other things, need to continue to incur considerable expenditures for provider networks, distribution channels and information systems in addition to the costs associated with the integration of these acquisitions. The integration of these complex businesses may result in, among other things, temporary increases in claims inventory or other service-related issues that may negatively affect the Company's relationship with its customers and contribute to increased attrition of such customers. The Company's results of operations could be adversely affected in the event that the Company experiences such problems or is otherwise unable to implement fully its expansion strategy.

The Company and certain of its subsidiaries are subject to capital surplus requirements by the California Department of Managed Health Care, the Georgia Department of Insurance, various other state Departments of Insurance and the Blue Cross Blue Shield Association. Although the Company believes that it is currently in compliance with all applicable requirements, there can be no assurances that such requirements will not be increased in the future.

From time to time, the Company and certain of its subsidiaries are parties to various legal proceedings, many of which involve claims for coverage encountered in the ordinary course of business. The Company, like HMOs and health insurers generally, excludes certain health care services from coverage under its HMO, PPO and other plans. The Company is, in its ordinary course of business, subject to the claims of its enrollees arising out of decisions to restrict treatment or reimbursement for certain services. The loss of even one such claim, if it results in a significant punitive damage award, could have a material adverse effect on the Company. In addition, the risk of potential liability under

punitive damage theories may increase significantly the difficulty of obtaining reasonable settlements of coverage claims.

In June 2000, the California Medical Association filed a lawsuit in U.S. district court in San Francisco against BCC. The lawsuit alleges that BCC violated the RICO Act through various misrepresentations to and inappropriate actions against health care providers. In late 1999, a number of class-action lawsuits were brought against several of the Company's competitors alleging, among other things, various misrepresentations regarding their health plans and breaches of fiduciary obligations to health plan members. In August 2000, the Company was added as a party to *Shane v. Humana*, et al., a class-action lawsuit brought on behalf of health care providers nationwide. In addition to the RICO claims brought in the California Medical Association lawsuit, this lawsuit also alleges violations of ERISA, federal and state "prompt pay" regulations and certain common law claims. In October 2000, the federal Judicial Panel on Multidistrict Litigation issued an order consolidating the California Medical Association lawsuit, the Shane lawsuit and various other pending managed care class-action lawsuits against other companies before District Court Judge Federico Moreno in the Southern District of Florida for purposes of the pretrial proceedings. In March 2001, Judge Moreno dismissed the plaintiffs' claims based on violation of the RICO Act, although the dismissal was made without prejudice to the plaintiffs' ability to subsequently refile their claims. Judge Moreno also dismissed, with prejudice, the plaintiffs' federal prompt pay law claims. On March 26, 2001, the California Medical Association filed an amended complaint in its lawsuit, alleging, among other things, revised RICO claims and violations of California law. A hearing on the plaintiffs' motion to certify a class was held in early May 2001. On May 9, 2001, Judge Moreno issued an order requiring that all discovery in the litigation be completed by December 2001, with the exception of discovery related to expert witnesses, which must be completed by March 15, 2002. In June 2001, the federal Eleventh Circuit Court of Appeals issued a stay of Judge Moreno's discovery order, pending a hearing before the Court of Appeals on the Company's appeal of its motion to compel arbitration (which had earlier been granted in part and denied in part by Judge Moreno). The financial and operational impact that these and other evolving theories of recovery will have on the managed care industry generally, or the Company in particular, is at present unknown.

The Company's future results will depend in large part on accurately predicting health care costs incurred on existing business and upon the Company's ability to control future health care costs through product and benefit design, underwriting criteria, utilization management and negotiation of favorable provider contracts. Changes in mandated benefits, utilization rates, demographic characteristics, health care practices, provider consolidation, inflation, new pharmaceuticals/technologies, clusters of high-cost cases, the regulatory environment and numerous other factors are beyond the control of any health plan provider and may adversely affect the Company's ability to predict and control health care costs and claims, as well as the Company's financial condition, results of operations or cash flows. In addition, actual or expected economic downturns could negatively affect the Company's results of operations as employers terminate existing employees or employees increase their utilization of medical care in anticipation of a loss of employer paid benefits. Periodic renegotiations of hospital and other provider contracts coupled with continued consolidation of physician, hospital and other provider groups may result in increased health care costs and limit the Company's ability to negotiate favorable rates. In recent years, large physician practice management companies have experienced extreme financial difficulties, including bankruptcy, which may subject the Company to increased credit risk related to provider groups and cause the Company to incur duplicative claims expense. Additionally, the Company faces competitive pressure to contain premium prices. Fiscal concerns regarding the continued viability of government-sponsored programs such as Medicare and Medicaid may cause decreasing reimbursement rates for these programs. Any limitation on the Company's ability to increase or maintain its premium levels, design products, implement underwriting criteria or negotiate competitive provider contracts may adversely affect the Company's financial condition or results of operations.

Managed care organizations, both inside and outside California, operate in a highly competitive environment that has undergone significant change in recent years as a result of business consolidations, new strategic alliances, aggressive marketing practices by competitors and other market pressures. Additional increases in competition could adversely affect the Company's financial condition, cash flows or results of operations. Additional increases in competition (including competition from market entrants offering Internet-based products and services), could adversely affect the Company's financial condition.

As a result of the Company's acquisitions, the Company operates on a select geographic basis nationally and offers a spectrum of health care and specialty products through various risk-sharing arrangements. The Company's health care products include a variety of managed care offerings as well as traditional fee-for-service coverage. With respect to product type, fee-for-service products are generally less profitable than managed care products. A critical component of the Company's expansion strategy is to transition over time the traditional insurance members of the Company's acquired businesses to more managed care products.

With respect to the risk-sharing nature of products, managed care products that involve greater potential risk to the Company generally tend to be more profitable than management services products and those managed care products where the Company is able to shift risks to employer groups. Individuals and small employer groups are more likely to purchase the Company's higher-risk managed care products because such purchasers are generally unable or unwilling to bear greater liability for health care expenditures. Typically, government-sponsored programs involve the Company's higher-risk managed care products. Over the past few years, the Company has experienced a decline in margins in its higher-risk managed care products and to a lesser extent on its lower-risk managed care and management services products. This decline is primarily attributable to product mix change, product design, competitive pressure and greater regulatory restrictions applicable to the small employer group market. From time to time, the Company has implemented price increases in certain of its managed care businesses. While these price increases are intended to improve profitability, there can be no assurance that this will occur. Subsequent unfavorable changes in the relative profitability between the Company's various products could have a material adverse effect on the Company's results of operations and on the continued merits of the Company's geographic expansion strategy.

Substantially all of the Company's investment assets are in interest-yielding debt securities of varying maturities or equity securities. The value of fixed income securities is highly sensitive to fluctuations in short- and long-term interest rates, with the value decreasing as such rates increase and increasing as such rates decrease. In addition, the value of equity securities can fluctuate significantly with changes in market conditions. Changes in the value of the Company's investment assets, as a result of interest rate fluctuations, can affect the Company's results of operations and stockholders' equity. There can be no assurances that interest rate fluctuations will not have a material adverse effect on the results of operations or financial condition of the Company.

The Company's operations are dependent on retaining existing employees, attracting additional qualified employees and achieving productivity gains from the Company's investment in technology. The Company faces intense competition for qualified information technology personnel and other skilled professionals. There can be no assurances that an inability to retain existing employees or attract additional employees will not have a material adverse effect on the Company's results of operations.

In December 2000, a wholly owned subsidiary of the Company completed its acquisition of certain mail order pharmaceutical service assets and conducts business as a mail order pharmacy. The pharmacy business is subject to extensive federal, state and local regulations, which are in many instances different from those under which the Company currently operates. The failure to properly adhere to these and other applicable regulations could result in the imposition of civil and criminal penalties, which could adversely affect the Company's results of operations or financial condition. In

addition, pharmacies are exposed to risks inherent in the packaging and distribution of pharmaceuticals and other health care products. Although the Company intends to maintain professional liability and errors and omissions liability insurance, there can be no assurances that the coverage limits under such insurance programs will be adequate to protect against future claims or that the Company will be able to maintain insurance on acceptable terms in the future.

Following the terrorist attacks of September 11, 2001, there have been various incidents of suspected bioterrorist activity in the United States. To date, these incidents have resulted in related isolated incidents of illness and death. However, federal and state law enforcement officials have issued public warnings about additional potential terrorist activity involving biological weapons. If the United States were to experience more widespread bioterrorist attacks, the Company's covered medical expenses could rise and the Company could experience a material adverse effect on its results of operations and financial condition.

### **ITEM 3. *Quantitative and Qualitative Disclosures About Market Risk***

There have been no material changes in market risk from that disclosed in the Company's Annual Report on Form 10-K for the year ended December 31, 2000.

## PART II OTHER INFORMATION

### ITEM 6. *Exhibits and Reports on Form 8-K*

#### (a) Exhibits

- 2.01 Amended and Restated Recapitalization Agreement dated as of March 31, 1995 by and among the Registrant, Blue Cross of California, Western Health Partnership and Western Foundation for Health Improvement, incorporated by reference to Exhibit 2.1 of the Registrant's Registration Statement on Form S-4 dated April 8, 1996
- 2.02 Amended and Restated Agreement and Plan of Merger dated as of November 29, 2000, by and among Cerulean Companies, Inc., the Registrant and Water Polo Acquisition Corp., incorporated by reference to Exhibit 2.01 of the Registrant's Current Report on Form 8-K dated March 15, 2001
- 3.01 Restated Certificate of Incorporation of the Registrant, incorporated by reference to Exhibit 3.1 of the Registrant's Current Report on Form 8-K filed on August 5, 1997.
- 3.02 Bylaws of the Registrant, incorporated by reference to Exhibit 4.2 of the Registrant's Registration Statement on Form S-8, Registration No. 333-90791
- 4.01 Specimen of common stock certificate of WellPoint Health Networks Inc., incorporated by reference to Exhibit 4.4 of Registrant's Registration Statement on Form 8-B, Registration No. 001-13083
- 4.02 Restated Certificate of Incorporation of the Registrant (included in Exhibit 3.01)
- 4.03 Bylaws of the Registrant (included in Exhibit 3.02)
- 4.04 Indenture dated as of July 2, 1999 by and between the Registrant and The Bank of New York, as trustee (including the form of Debenture attached as Exhibit A thereto), incorporated by reference to Exhibit 4.04 to the Registrant's Quarterly Report on Form 10-Q for the quarter ended March 31, 2000.
- 4.05 Amended and Restated Indenture dated as of June 8, 2001 by and between the Registrant and The Bank of New York, as trustee, incorporated by reference to Exhibit 4.05 to the Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2001.
- 4.06 Form of 6<sup>3</sup> / 8 % Note due 2006, incorporated by reference to Exhibit 4.1 to the Registrant's Current Report on Form 8-K dated June 12, 2001.

#### (b) Reports on Form 8-K

On July 10, 2001, the Company filed a Current Report on Form 8-K which reported that the Company's subsidiary Blue Cross of California ("BCC") intended to modify its incentive compensation mechanisms with participating medical groups serving members of BCC's health maintenance organization.

**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

**WELLPOINT HEALTH NETWORKS INC.**  
Registrant

Date: November 9, 2001

By: /s/ LEONARD D. SCHAEFFER  

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Leonard D. Schaeffer  
*Chairman of the Board of Directors  
and Chief Executive Officer*

Date: November 9, 2001

By: /s/ DAVID C. COLBY  

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David C. Colby  
*Executive Vice President  
and Chief Financial Officer*

Date: November 9, 2001

By: /s/ KENNETH C. ZUREK  

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Kenneth C. Zurek  
*Senior Vice President, Controller  
and Taxation*



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